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TAGS: EFIN ECON PGOV HO IMF
SUBJECT: HONDURAS ECONOMIC REFORM: CENTRAL BANK REFORMED AND MODERNIZED BY NEW LAW

REF: A) 04 Tegucigalpa 2765

B) 03 Tegucigalpa 2062
C) 04 Tegucigalpa 232

¶1. (U) SUMMARY: In September 2004, at IMF insistence, the GOH passed four banking reform laws aimed at strengthening the nation's financial system. This is the second in a series of four cables that analyze each of these laws, assess their impacts on the Honduran financial system, and outline challenges of implementation or additional needed reforms that remain. Ref A analyzed the reform of the deposit insurance agency; this cable focuses on the reform of the Central Bank.

¶2. (U) The Central Bank reform law, which took effect on September 22, 2004, changes the structure of the Central Bank's Board of Directors, provides greater flexibility in the areas of exchange rate policy, monetary policy, and liquidity management, and provides for a stronger capitalization of the Central Bank from the central government. In many of these areas, the law creates the legal opportunity for reforms which the bank plans to implement only gradually. These changes should strengthen the financial system by allowing the Central Bank greater political autonomy and more flexibility in its operations. However, increased capacity-building and training will be necessary if the Central Bank is to implement fully all the changes permitted by the new law. END SUMMARY.

Background: The Need for Reform

¶3. (SBU) As summarized in ref B, a 2003 joint IMF/World Bank "Financial System Stability Assessment" for Honduras concluded that the Honduran banking system is "highly fragile at a systemic level, impairing sustainable economic growth," and outlined several reforms needed to strengthen the system. These reforms were then incorporated into the Letter of Intent signed by the GOH and the IMF in February 2004, which required the passage of four financial sector reform bills: the Deposit Insurance Law; the Central Bank of Honduras Law; the Banking Commission Law; and a new Financial Institutions Law.

¶4. (SBU) Specific to the Central Bank, the FSAP identified a number of weaknesses, including both credit and operational risks in the payments system, tension between monetary policy and exchange rate policy, and a lack of political autonomy which could leave the Central Bank Board of Directors vulnerable to political influences. However, in response to these weaknesses, the report recommended incremental improvements to the Central Bank's legal framework and operations, rather than a major overhaul of the bank's structure or management.

Changes Under The New Law

¶5. (U) Of the four laws, the Central Bank reform law makes the least dramatic short-term changes in the operation of the Honduran financial sector. The law grants no new responsibilities to the Central Bank, but revises previous legislation to lift legal restrictions against certain kinds of Central Bank operations. The Bank must now choose how and when to take advantage of this new flexibility to gradually modernize and enhance its services.

¶6. (U) EconOff met with Vice President of the Central Bank Analia Napky on November 24 and received a detailed overview of the ways that the new law will give greater flexibility to the Bank's operations. Napky highlighted three broad areas of reform in the new law: changes to the structure of the Central Bank's Board of Directors; greater flexibility in the areas of exchange rate policy, monetary policy, and liquidity management; and a stronger capitalization of the

Central Bank from the central government.

Make-up of the Board of Directors

¶7. (U) Presently, the Central Bank is managed by five officers: the President, Vice President, and three other directors. All five are appointed by the President and serve a four-year term concurrent with the President's term. This arrangement leads to two potential problems. First, there is a lack of policy continuity and a loss of institutional memory as the entire board of directors leaves office at the same time as the entire GOH financial team every four years. Second, the Bank's political independence may be compromised, as the entire board is appointed by a newly-elected President and thus tends to be directly associated with that President and his administration.

¶8. (U) Under the new law, the appointments of the three lower directors are staggered. The Central Bank President and Vice President will still be appointed by the newly-elected President of Honduras and will serve terms concurrent with his term. However, the other three directors will serve terms that begin in each of the next three years. As a result, an incoming President can only appoint two-fifths of the Central Bank board upon arrival in office, and will start off working with a Central Bank board three-fifths of which was appointed by his predecessor. According to Napky, the biggest gain of this new arrangement is that most of the Central Bank's Board of Directors will remain in place across a Presidential transition, enabling the bank to maintain policy continuity and emphasizing the Central Bank's political independence.

Greater Operational Flexibility

¶9. (U) The new law grants the Central Bank greater flexibility in its operations in the areas of exchange rate policy, monetary policy, and management of the payments system, by lifting restrictions that existed under previous legislation. While Napky stressed that the Central Bank does not plan to adopt reforms in all of these areas at once, she praised the law for providing the necessary legal framework for future developments, so that over time the bank's operations may be modernized.

¶10. (SBU) The new law gives the Central Bank the flexibility to change its exchange rate management, though Napky stressed that in the short term they have no intention of doing so. Previously, the Central Bank was required by law to purchase all foreign currency from Honduran banks at the end of each day, and make it available to banks only through means of an auction held once and only once per week. The rate itself is set through means of a managed float, with the nominal rate devaluing within a band at roughly six percent per year to keep the trade-weighted real exchange rate stable. The new law loosens these requirements somewhat, and hence grants the Central Bank the legal ability to move to a more flexible exchange rate regime in the future. Napky said that this legal change was made by means of a deliberately subtle change in wording, so as not to generate either worries or expectations that the Central Bank plans to change its exchange rate policy in the near future. The change in wording is so subtle, she joked, that "only a lawyer or a central banker would understand what we meant." Napky said that significant changes to the current exchange rate regime might only be made "in 10 or 20 years time, if the conditions are right."

¶11. (U) The new law also gives the Central Bank greater flexibility in the exercise of monetary policy. Currently, the Central Bank's only tool for conducting open market transactions is the issuance of Certificates of Monetary Absorption (known as CAMs in Spanish). However, until the September reform law, these CAMs were non-negotiable, and therefore no secondary market for these instruments currently exists. Also, the CAMs currently exist exclusively as actual pieces of paper, and cannot be issued or traded electronically. The new law lifts both of these restrictions. First, under the new system, while the auction of these CAMs will remain the Central Bank's main instrument of monetary policy, the CAMs will become negotiable. Second, the law will permit "dematerialization," that is, allowing CAMs to be bought and sold electronically, apart from the transfer of any physical document. (Note: The Ministry of Finance is currently contemplating a similar reform in the area of government bonds, which are currently also non-negotiable and limited to their face value. End note.)

¶12. (U) The law also allows the Central Bank a more active role in its function as the hub of the payments system. As with the issuance of CAMs and bonds described above, until

the recent reforms, the payment system still required checks to be exchanged physically as there was no legal framework for the recognition of electronic signatures and documents. The new law removes this restriction, and allows the Central Bank to grant overnight loans and short-term loans in the process of managing the payments system. The result should be an improvement in the efficiency of the payments system, reducing the time and costs of routine transactions, as well as an eventual reduction in the risk that a failed large transaction would trigger a disruption throughout the system. As a result of the new law, Honduras moves closer to compliance with the internationally-recognized Committee on Payment and Settlement Systems (CPSS) Core Principles for systematically important payment systems.

Capitalization

¶13. (U) Finally, the law establishes a mechanism through which the government capitalizes the Central Bank for past operating losses, as explicitly required by the February Letter of Intent. The law requires the Ministry of Finance to take on the Central Bank's accumulated losses from the period 1997 to 2004 - approximately 3.2 billion lempiras ($177 million) at the end of 2003. The exact cost of this operation must be specified within the first two months of 2005, at which time government bonds will be issued by the Ministry of Finance and the cost will be incorporated into the central government accounts.

The Challenge of Implementation

¶14. (U) The Central Bank is currently preparing the regulations for the new law, in conjunction with the National Banking and Insurance Commission (CNBS) and with the assistance of consultants funded by the IDB and the World Bank. Additional regulations on the management of the payment system are also being drafted, though Napky said it has not yet been decided if these changes will be brought into effect through the regulations of the Central Bank reform law or whether they will require a new law to be brought to Congress next year.

¶15. (U) As for implementation, the Central Bank reform law imposes no new responsibilities upon the Central Bank. However, since it does allow the bank to modify its operations, technical assistance and training will be needed to enable the bank to take on new activities. Napky also stressed that as the bank modernizes its activities over time, there will be a need for new computer hardware and software, and training to use them, none of which is currently provided for in the Central Bank's budget. Much assistance of this sort is already being provided by the World Bank (as part of its Financial Sector Strengthening Credit) and the IDB. Napky hopes to raise the possibility of additional assistance of this type during the upcoming assessment visit of Treasury Department specialists in government debt issuance and management, tentatively scheduled for January 2005.

Comment: Making Progress in Small Steps

¶16. (U) Comment: The Central Bank reform law makes no major structural or operational changes, and is arguably the least innovative of the four recent financial sector reform laws. However, the law does contain several important modifications to the legal framework governing the Central Bank, which in turn will allow a series of incremental improvements in the way the bank conducts its operations. While Napky was obviously pleased and excited about the prospects of modernizing the Central Bank's activities, she, like any good central banker, also places a high premium on stability and predictability, and is not about to run off impulsively on a series of rapid and potentially disruptive changes. End Comment.

Palmer